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Learning Curve Asset-Backed Commercial Paper

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October 2004**

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Introduction

The rise in securitisation has led to the growth of short-term instruments backed by the cash flows from other assets, known as *asset-backed commercial paper* (ABCP). Securitisation is the practice of using the cash flows from a specified asset, such as residential mortgages, car loans or commercial bank loans, as backing for an issue of bonds. The assets themselves are transferred from the original owner (the *originator*) to a specially created legal entity known as a *special purpose vehicle* (SPV), so as to make them separate and bankruptcy-remote from the originator. In the meantime, the originator is able to benefit from capital market financing, often charged at a lower rate of interest than that earned by the originator on its assets. Securitised products are not money market instruments, and although ABCP is, most textbooks treat ABCP as part of the structured products market rather than as a money market product.

Generally securitisation is used as a funding instrument by companies for three main reasons: it offers lower-cost funding compared with than traditional bank loan or bond financing; it is a mechanism by which assets such as corporate loans or mortgages can be removed from the balance sheet, thus improving the lenders return on assets or return on equity ratios; and it increases a borrowers funding options. When entering into securitisation, an entity may issue term securities against assets into the public or private market, or it may issue commercial paper via a special vehicle known as a *conduit*. These conduits are usually sponsored by commercial banks.

Entities usually access the commercial paper market in order to secure permanent financing, rolling over individual issues as part of a longer-term *programme* and using interest-rate swaps to arrange a fixed rate if required. Conventional CP issues are typically supported by a line of credit from a commercial bank, and so this form of financing is in effect a form of bank funding. Issuing ABCP enables an originator to benefit from money market financing that it might otherwise not have access to because its credit rating is not sufficiently strong. A bank may also issue ABCP for balance sheet or funding reasons. ABCP trades however, exactly as conventional CP. The administration and legal treatment is more onerous however, because of the need to establish the CP trust structure and issuing SPV. The servicing of an ABCP programme follows that of conventional CP and is carried out by the same entities, such as the “Trust” arms of banks such JPMorgan Chase, Deutsche Bank and Bank of New York.

The box details an hypothetical ABCP issue and typical structure.

Basic characteristics

Asset-backed CP programmes are invariably issued out of specially-incorporated legal entities (the SPV, sometimes called the SPC for Special Purpose Corporation)), which in the money markets are known as conduits. They are typically established by commercial banks and finance companies to enable them to access Libor-based funding, at close to Libor, and to obtain regulatory capital relief. This can be done for the bank or a customer.

An ABCP conduit has the following features:

- it is a bankruptcy-remote legal entity that issues commercial paper to finance a purchase of assets from a seller of assets;
- the interest on the CP issued by the conduit, and its principal on maturity, will be paid out of the receipts on the assets purchased by the conduit;
- conduits have also been set up to exploit credit arbitrage opportunities, such as raising finance at Libor to invest in high-quality assets such as investment-grade rated structured finance securities that pay above Libor.

The assets that can be funded via a conduit programme are many and varied; to date they have included:

- trade receivables and equipment lease receivables;
- credit card receivables;
- auto loans and leases;
- corporate loans; franchise loans, mortgage loans;
- real-estate leases;
- investment-grade rated structured finance bonds such as ABS, MBS and CDO notes;
- future (expected) cash flows.

Conduits are classified into a “programme type”, which refers to the make-up of the underlying asset portfolio. This can be single-seller or multi-seller, which indicates how many institutions or entities are selling assets to the conduit. They are also designated as funding or securities credit arbitrage vehicles. A special class of conduit known as a Structured Investment Vehicle (SIV, sometimes called a Special Investment Vehicle) exist that issue both CP and Medium-Term Notes (MTNs), and which are usually credit arbitrage vehicles.

Credit enhancement and liquidity support

To make the issue of liabilities from a conduit more appealing to investors (or to secure a particular credit rating), a programme sponsor will usually arrange some form of credit enhancement and/or back-up borrowing facility. Generally two types of credit enhancement are used, either “pool-specific” enhancement or “programme-wide”. The first arrangement will cover only losses on a specific named part of the asset pool, and cannot be used to cover losses in any other part of the asset pool. Programme-wide credit enhancement is a fungible layer of credit protection that can be drawn on to cover losses from the start or if any pool-specific facility has been used up.

Pool-specific credit enhancement instruments include the following:

- Over-collateralisation, where the nominal value of the underlying assets exceeds that of the issued paper;
- Surety bond: a guarantee of repayment from a sponsor or other bank;
- Letter of credit: a stand-by facility that the Issuer can use to draw funds from;
- Irrevocable loan facility
- Excess cash, invested in eligible instruments such as T-bills.

The size of a pool-specific credit enhancement facility is quoted as a fixed percentage of the asset pool. Programme-wide credit enhancement is in the same form as pool-specific enhancement, and acts as a second layer of credit protection. It may be provided by a third party such as a commercial bank as well as by the sponsor.

Liquidity support is separate from credit enhancement. While credit enhancement facilities cover losses due to asset default, liquidity providers undertake to make available funds should these be required for reasons other than asset default. A liquidity line is drawn on, if required, to ensure timely repayment of maturing CP. This might occur because of market disruption (such that the Issuer could not place new CP), an inability of the issuer to roll maturing CP, or because of asset and liability mismatches. This last item is the least serious situation, and reflects that in many cases long-dated assets are used to back short-dated liabilities, and cashflow dates often do not match. The availability of a liquidity arrangement provides comfort to investors that CP will be repaid in full and on time, and is usually arranged with a commercial bank. It is usually provided as a loan agreement, of an amount equal to 100% of the face amount of CP issued, under which the liquidity provider agrees to lend funds to the conduit as required. The security for the liquidity line comes from the underlying assets.

Figure 1 illustrates a typical ABC structure issuing to the USCP and ECP markets.

Figure 2 shows a multi-seller conduit set up to issue in the ECP market.

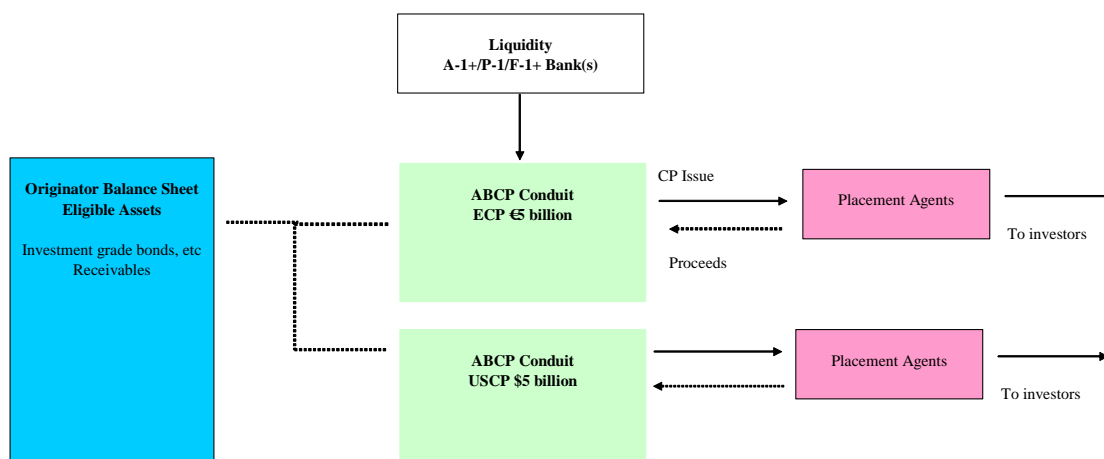


Figure 1 Single-seller conduit

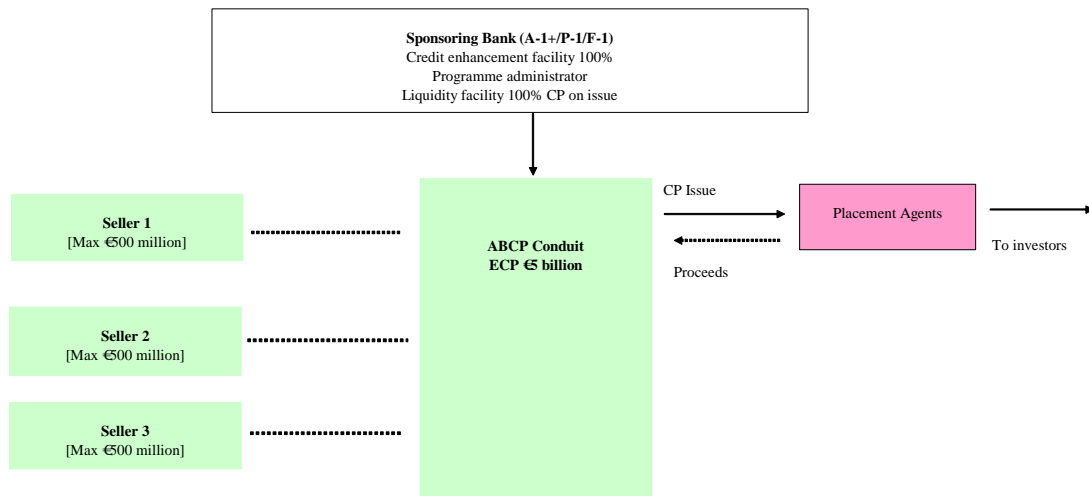


Figure 2 Multi-seller EABCP conduit

Market volumes

The CP market is a large and liquid market in which capital is raised efficiently. The ABCP markets have also grown such that they represent considerable depth and liquidity. For instance, as at 31 March 2004, the US CP market had \$1.28 trillion of outstanding paper, of which \$650 billion was ABCP. Figure 3 shows the trend in volume, with the increasing share of ABCP apparent.

The Euro CP market has also been experiencing this growth. Figure 4 shows the ECP market outstandings at end of Quarter 1, 2004, while Figure 5 shows the Euro ABCP market as a percentage of the total ECP market.

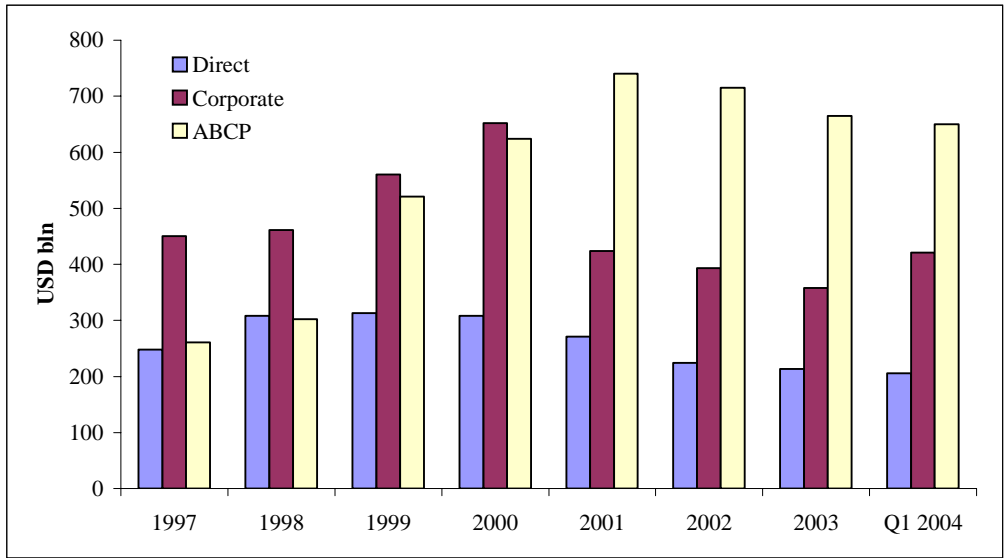


Figure 3 Total US CP market volumes, 2004
(Source: Merrill Lynch)

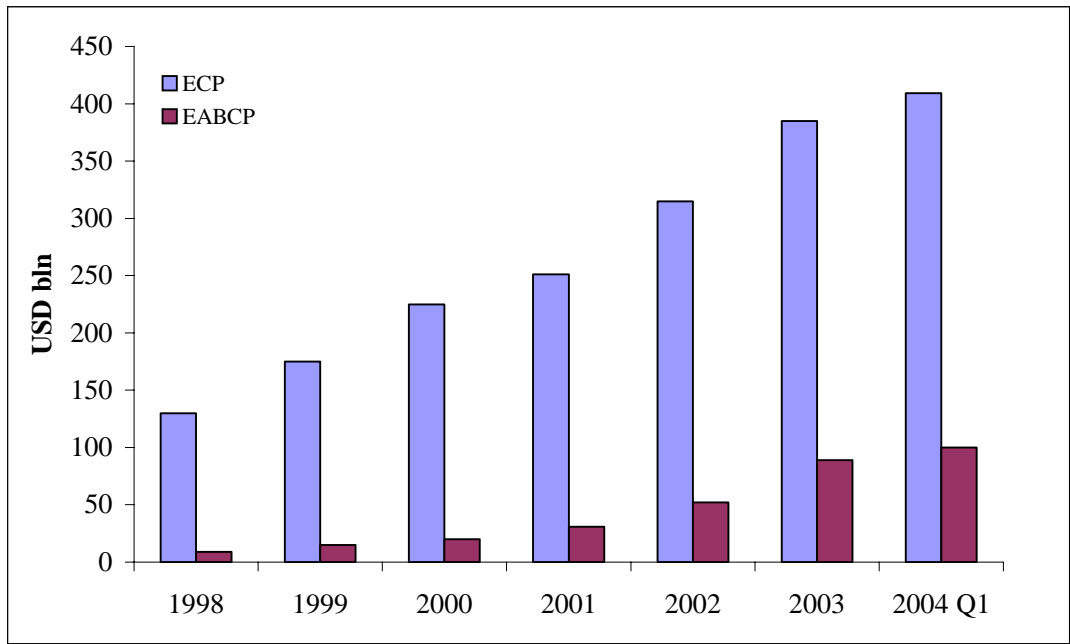


Figure 4 ECP market outstanding, 2004
(Source: Merrill Lynch)

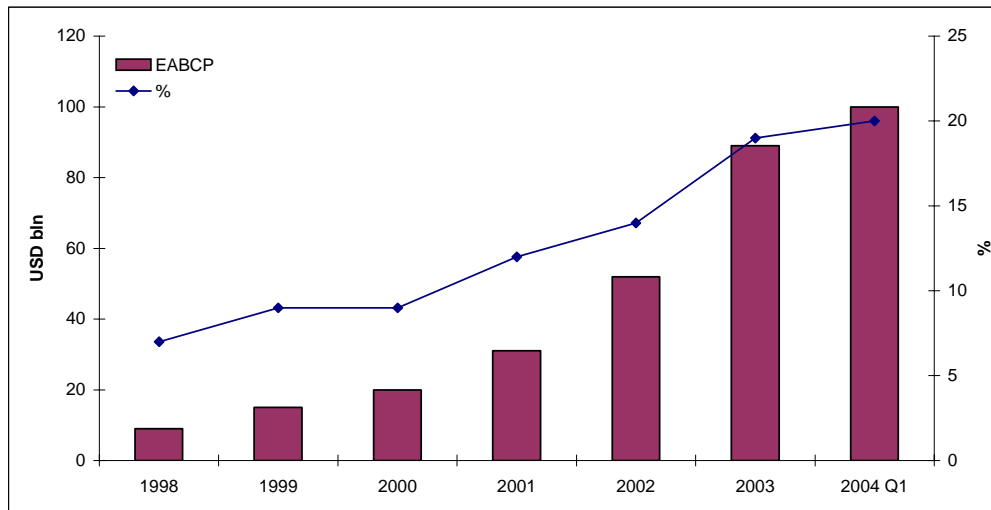


Figure 5 EABCP market as share of total ECP market, 2004
 (Source: Merrill Lynch)

Example: Illustration of ABCP structure

In Figure 6 we illustrate an hypothetical example of a securitisation of bank loans in an ABCP structure. The loans have been made by ABC Bank plc and are secured on borrowers’ specified assets. They are denominated in sterling. These might be a lien on property, cash flows of the borrowers’ business or other assets. The bank makes a “true sale” of the loans to a special purpose vehicle, named Claremont Finance. This has the effect of removing the loans from its balance sheet and also protecting them in the event of bankruptcy or liquidation of ABC Bank. The SPV raises finance by issuing commercial paper, via its appointed CP dealer(s), which is the Treasury desk of MC investment bank. The paper is rated A-1/P-1 by the rating agencies and is issued in US dollars. The liability of the CP is met by the cash flow from the original ABC Bank loans.

ABC Manager is the SPV manager for Claremont Finance, a subsidiary of ABC Bank. Liquidity for Claremont Finance is provided by ABC Bank, who also act as the hedge provider. The hedge is effected by means of a swap agreement between Claremont and ABC Bank; in fact ABC will fix a currency swap with a swap bank counterparty, who is most likely to be the swap desk of MC investment bank. The trustee for the transaction is Trust Bank Limited, who act as security trustee and represent the investors in the event of default.

The other terms of the structure are as follows:

Programme facility limit:	US\$500 million
Facility term:	The facility is available on an uncommitted basis renewable annually by the agreement of the SPV manager and the security trustee. It has a final termination date five years from first issue.
Tenor of paper:	Seven days to 270 days
Prepayment guarantee:	In the event of pre-payment of a loan, the seller will provide Claremont Finance with a guaranteed rate of interest for the relevant interest period.
Hedge agreement:	Claremont Finance will enter into currency and interest-rate swaps with the hedge provider to hedge any interest-rate or currency risk that arises.
Events of default:	Under event of default the issuance programme will cease and in certain events will lead to Claremont Finance to pay loan collections into a segregated specific collection account. Events of default can include non-payment by Claremont Finance under the transaction documentation, insolvency or raking of charge (where the charge ceases to be a first ranking charge over the assets of Claremont Finance).
Loans guarantee:	Loans purchased by Claremont Finance will meet a range of eligibility criteria, specified in the transaction offering circular. These criteria will include requirements on currency of the loans, their term to maturity, confirmation that they can be assigned, that they are not in arrears, and so on.

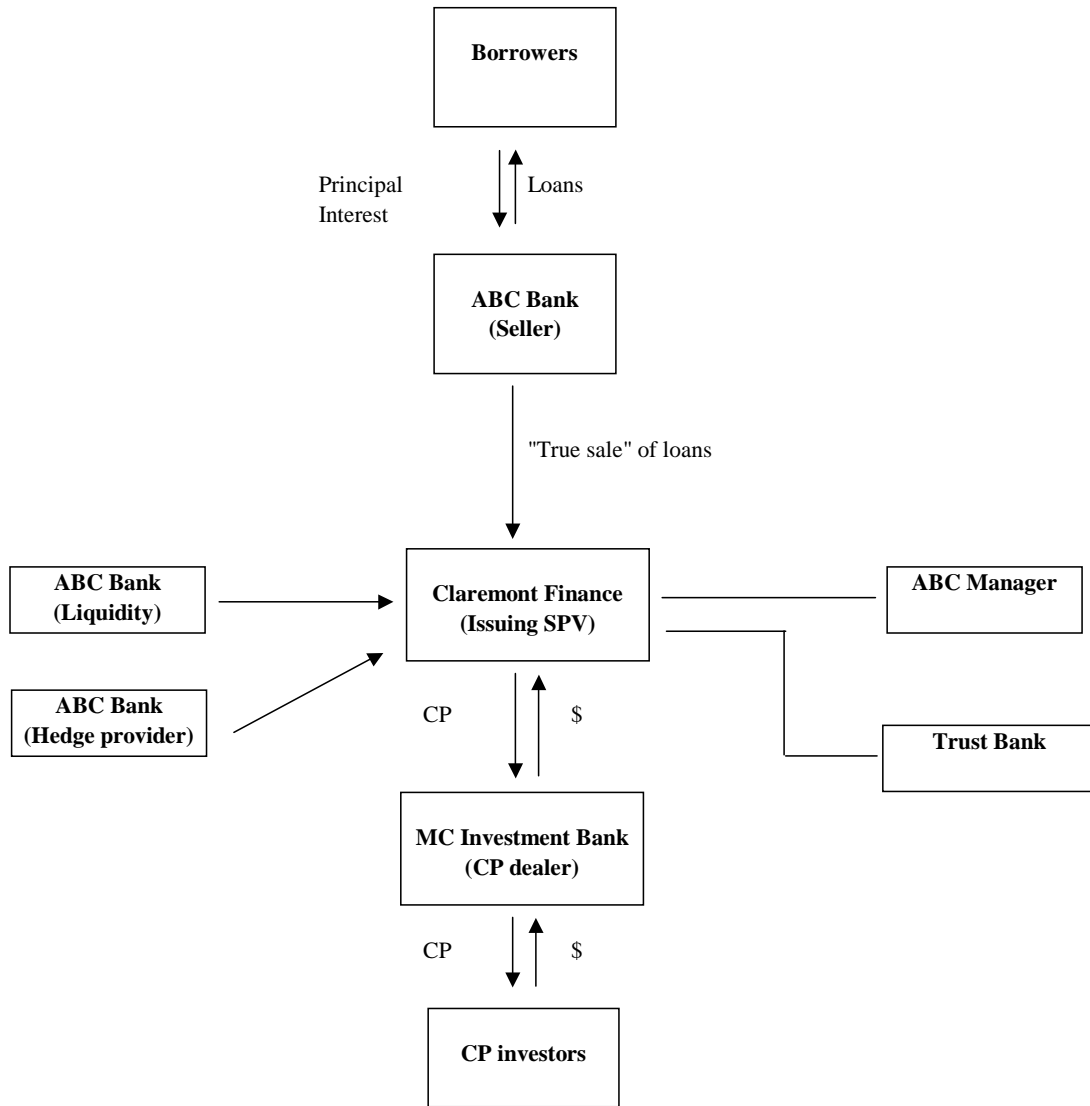


Figure 6 "Claremont Finance" ABCP structure